June 14, 2001

VIA HAND DELIVERY

The Honorable James Connelly, Chairman
The Honorable W. Robert Keating, Commissioner
The Honorable Paul B. Vasington, Commissioner
The Honorable Eugene J. Sullivan, Jr., Commissioner
The Honorable Deirdre K. Manning, Commissioner
Department of Telecommunications and Energy
One South Station
Boston, Massachusetts 02110

Re: Competitive Market Initiatives - Comments

Dear Chairman and Commissioners:

I am writing to you on behalf of Sithe New England Holdings ("Sithe") in response to your request for comments regarding the state of the competitive electric market in Massachusetts. Sithe applauds the efforts of the Department of Telecommunications and Energy ("Department" or "DTE") in reviewing the state of electricity markets at this critical time.

Background

Sithe is a supplier of electricity in wholesale power markets in the region. Sithe owns over 2000 MW of existing fossil generation in New England (with most of this capacity located in Massachusetts), and has nearly 2400 MW of additional new gas-fired combined cycle generation under construction with an in-service date of Summer 2002. Sithe has a strong interest in the health of the region's wholesale markets and the Commonwealth's retail markets which serve Massachusetts consumers

As you know, this topic was the subject of a technical conference held by the DTE on May 31, 2001. Sithe has reviewed the transcript from that technical conference, and appreciates the opportunity to submit comments to the DTE on certain issues raised during that conference.

Sithe offers comments on the following topics: the benefits of generation competition; the importance of price-responsive demand; prices in the region's wholesale generation market; and the need for installed generation capacity.

Benefits of Competition

As Chairman Connelly noted at the May 21st technical session, Massachusetts is nearly half way through the seven-year transition to retail competition established by the 1997 Electric Restructuring Act (Tr. at 4). While almost four years have passed since the enactment of this landmark legislation, notably it has been only two years since the opening of regional wholesale markets administered by the Independent System Operator - New England ("ISO-NE"). Sithe agrees that in the Commonwealth's retail markets, "much has been achieved…but not all" (Tr. at 6) - in both retail and wholesale generation markets.

Even so, as noted by Cheryl LaFleur of Massachusetts Electric Company, competition has already led to customer savings during the past few years. Ms. LaFleur stated that her company's retail customers had saved $500 million since March 1998 when retail open access commenced in the Commonwealth (Tr. at 18). This is just one example of benefits in the past few years that have resulted from the introduction of competition into the electric market.

Sithe has recently analyzed other forms of savings which have inured to customers as the result of the opening of competitive electricity markets. Given Sithe's role as a generator, Sithe focused its cost/savings analysis on power generation costs. Sithe's analysis of cost recovery related to the Boston Edison/Sithe fossil generating assets prior to and after restructuring shows that there have been significant savings in cost recovery paid by consumers in the post-divestiture, market-based rate period (see Table 1 on page 4).[1,2]

For example, during 1996-1997, Boston Edison is estimated to have collected from ratepayers $346 million associated with its ownership and operations of the fossil generating units in Massachusetts. This figure excludes fuel and variable operations and maintenance ("O&M") costs incurred by Boston Edison and also charged to consumers. By contrast, Sithe is estimated to have been paid $220 million in energy, capacity,

[1] This cost recovery comparison was prepared by Dr. Susan Tierney of Lexecon Inc., in an affidavit submitted on June 4, 2001, on behalf of Sithe in the Federal Energy Regulatory Commission ("FERC") Docket #EL01-79-000. This affidavit, which is provided as Attachment 1 to these comments, describes the method and data used by Tierney to compare: (a) the revenue requirement collected by Boston Edison for the fossil generating units during the two full years prior to divestiture (1996-1997), with (b) the costs of the plants during the Transition Agreement period (May 1998-November 1998) in which Sithe sold energy, capacity and ancillary services to Boston Edison under a cost-based contract rate, and (c) the net revenues that Sithe has received from the energy, ICAP and ancillary service markets, and from uplift during the two-year period beginning May 1999 when the region's wholesale energy markets commenced. Tierney's analysis compares these costs using both a $/kW-yr measure (to reflect only fixed cost recovery, net of variable fuel and O&M costs) and $/MWH (using total revenues, without netting out fuel or variable O&M costs), as well as total amount paid (in nominal dollars) for non-fuel costs.

[2] As part of its filing in FERC Docket #EL01-79-000, Sithe submitted numerous documents in addition to the Tierney Affidavit. Because of the volume of Sithe's FERC filing, Sithe has not attached the entire filing to these comments. However, all documents can be provided to the DTE if the Department so requests.

ancillary and uplift revenues (excluding fuel and variable O&M costs) over a more recent two-year period (May 1999-April 2001, the first two-year period since the opening of the energy market in New England).

Sithe's market-based revenues in the past two years – whether calculated on the basis of total net revenues or $/kw-year – are much lower than those received by Boston Edison during the two years prior to divestiture. On a total net revenue basis, Boston Edison received 57 percent more revenues than Sithe, not counting for the effect of inflation. On a $/kW-year basis, Boston Edison received (during the pre-divestiture "cost-based" rate period) 49 percent more than Sithe (during the market-based period, from 5/1999-4/2001). These are the appropriate bases for comparing Sithe's versus Boston Edison's/NSTAR's cost recovery for the fixed costs associated with these generating assets.

Sithe notes that the figures for cost recovery on a simple $/MWH basis inappropriately suggest that Sithe's revenues are higher than those previously paid to Boston Edison, since these revenues are distorted by various influences. For example, most of the change in $/MWH between Boston Edison's cost recovery (1996-1997) and Sithe's market-based cost recovery (5/1999-4/2001) results from changes in fuel prices. Direct and indirect fuel costs during the most recent two year period (5/1999-4/2001) were 35 percent higher than they were in 1996-1997; since the $/MWH figures include fuel prices, these higher fuel costs contribute to the higher $/MWH in the recent period. Additionally, generation output at the fossil generating units analyzed here was 50 percent higher during 1996-1997 when Boston Edison owned the plants than during the recent two-year period under Sithe's ownership. (There were significant nuclear outages during the 1996-1997 period, causing certain fossil generation, like the Boston Edison generating units, to operate at higher capacity factors than they would when the nuclear plants are operating.) This fact of higher plant output during 1996-1997 causes Boston Edison's higher absolute dollar amount of revenue recovered for fixed costs to be spread across more megawatt hours of output, thus lowering the $/MWH figure. Additionally, there are relatively high variable operating costs associated with current ISO-NE operating practices, which cause Sithe's plants to be operated frequently at their relatively inefficient, low operating levels. This fact tends to increase the $/MWH figure for Sithe.

Table 1
Comparison of Cost Recovery for Fossil Generating Assets:
Boston Edison (NSTAR) v. Sithe

Time period analyzed	Basis for cost recovery	Cost recovery in average $/kW-year	Cost recovery in average $/MWH	Total net revenues (excluding variable costs) – 2 years
Boston Edison (NSTAR) ownership (1996-1997)	Cost-based base rates and fuel clause	$78.93	$61.52	$ 346 million
Sithe Transition Contract - Sithe ownership (5/98-11/98)	Cost-based contract	$107.95	$51.09	---
Sithe ownership (5/1999-4/2001)	Market-based rates	$53.04	$77.72	$220 million

In sum, this analysis indicates that while competition is still in a transition phase, it still has brought about considerable hoped-for benefits with respect to lower costs recovered from consumers.

The Importance of Price-responsive Demand

Many commenters at the May 31st technical conference discussed the importance of sending real-time price signals to consumers. Sithe has already gone on record at the DTE in support of enhanced metering and price-responsive demand in the development of well-functioning wholesale and retail power markets. In its comments submitted to the Department in D.T.E. 00-41 in 2000, Sithe stated:

> The key to controlling such [spot energy market price] spikes is not in capping prices but in enabling the market itself to respond to spikes. As shown below, in well-functioning spot markets, price balances supply and demand.
>
> Policymakers and market participants alike have endorsed the importance of introducing a demand-responsive element into *wholesale* energy spot markets in New England, most notably in the form of the recently FERC-approved proposal for a multi-settlement system ("MSS") in which both demand and supply bids will be used to clear the market…. Demand-responsive bids have been seen as key to a properly functioning, efficient spot market for electricity. [footnote omitted]
>
> [The MSS] will go only part way toward fostering the development of price-responsive demand in the *end-use* market. Price-

> responsiveness among end-users is also essential to well-functioning power markets….
>
> To align changes in price-responsive demand mechanisms in retail markets with [those] necessary in wholesale markets, additional work is needed by state commissions….
>
> Two main things are needed to develop price-responsive demand. First, customers must have the opportunity to be exposed to actual market prices. When the customer is paying fixed prices for energy, and when he sees a bill that does not tie usage at certain hours with electricity prices in the generation markets, his incentive to reduce consumption at peak is highly attenuated…As long as customers can rely on standard offer or default service at fixed prices that do not reflect actual market prices, they will be indifferent to wholesale market volatility.
>
> Second, customers also need access to enhanced delivery services that enable them to know, understand and respond to real-time prices. Such services require equipment such as hourly meters and data communication devices.[3]

Sithe continues to view enhanced metering and price-responsive demand as critical elements of both retail and wholesale market design. We recognize that in D.T.E. 00-41 the Department stated its intention to open a proceeding to establish terms and conditions by which distribution companies will install advanced metering equipment, and that the Department completed the first phase of the investigation on May 18, 2001. Sithe urges the adoption of additional retail market rules and policies to hasten the introduction of advanced meters, especially among large customers, since the ability for consumers to see prices is important, if not essential, for those consumers to act on the option of responding to prices in real time.

Prices in the Region's Wholesale Market

Sithe agrees with several commenters at the technical session that changes in fuel prices in the past year have had an important impact on electricity prices in the region's wholesale markets. As Thomas May of NSTAR stated on May 31st, we are in "the worst energy crunch we've experienced in 25 years...with the price of natural gas tripling overnight and the oil prices going from 15 to 35 dollars a barrel, naturally there was a

[3] *See* Sithe New England Holdings LLC Initial Comments in D.T.E. 00-41, *Investigation of the Department of Telecommunications and Energy into whether (1) metering, meter maintenance and testing, customer billing and information services should be unbundled; and (2) the service territories of distribution companies should remain exclusive, as required in G.L. c. 164, § 1B* (2000), pp. 5-7, 10-11 (emphasis in original).

disruption in the wholesale marketplace and a disruption in the nice transition from standard-offer to market prices" (Tr. at 12).

Sithe also agrees with James Mahoney of PG&E National Energy Group that the conventional wisdom in New England is that wholesale prices greatly exceed standard offer service (Tr. at 169-170). In Sithe's own analysis, *Power Plant Investment and Regional Electricity Markets*, May 2001,[4] prices averaged $39/megawatt-hour in New England's spot market over the May 1999-March 2001 period, and fell below $75 per megawatt-hour in 97 percent of the hours (Attachment 2 at 8-10).

Like many of the commenters (including Mr. Mahoney of PG&E National Energy Group (Tr. at 168-169)), Sithe agrees that energy prices are starting to stabilize, with forward prices for the upcoming quarters and calendar years reflecting market participants' expectations that oil and gas prices will actually decline and new efficient capacity additions will come on line. By the end of 2002, the region will have approximately 10,000 MW of additional new capacity in service, creating further price pressure in the wholesale market.

Installed Capacity ("ICAP")

In response to statements made by Mr. Alex Galatic on behalf of Strategic Energy (Tr. at 94-97), Sithe wishes to clarify certain aspects relating to ICAP. Mr. Galatic's comments leave the impression that ICAP deficiency charges are something new to the region with the advent of competition, that ICAP is unregulated, that ICAP is "like a tax," and that ICAP does not go to develop new generation. Sithe wishes to set the record straight with respect to these points.

First, ICAP is not new. Long ago, NEPOOL adopted a requirement that load-serving entities maintain capacity to cover their customers' peak load and reserve requirements, and FERC long ago approved an installed capacity deficiency charge for the New England area. The ICAP charge is paid only if a load-serving entity fails to buy adequate reserve capacity in advance. If the load-serving entity complies with its obligations through its own generating resources and/or bilateral contracts and is not "deficient" (i.e., its capacity commitments adequately cover its capacity obligations), the load-serving entity pays no capacity deficiency charge. Presumably, the load-serving entity will find the least-cost means to satisfy its requirements, which will likely be a bilateral contract (at prices below the ICAP charge, which includes a penalty amount) where there is adequate regional capacity available for contract.

Second, ICAP is regulated. ICAP deficiency charges are subject to oversight by the Federal Energy Regulatory Commission.

Third, ICAP is not a tax. Again, a load-serving entity that holds enough capacity to meet its load and reserve requirements would pay no installed capacity deficiency charge at all.

[4] This analysis is provided as Attachment 2 to these comments.

Finally, ICAP (or some compensation mechanism like it) supports new generation by sending a signal to new investors that they will receive a revenue stream to compensate them for their investment. As shown in the analysis Sithe commissioned with respect to "Power Plant Investment and Regional Electricity Markets" (May 2001) (Attachment 2 to Sithe's comments), ICAP (or something like it) is needed to assure adequate entry of new generation capacity for reliability purposes. Since revenues from reliable spot energy and ancillary services markets are not adequate to compensate investors in new generation capacity, an additional compensation mechanism is necessary to make up the difference in revenues between what can be reasonably expected to be produced in energy and ancillary service markets, and what is needed to ensure adequate and sustainable investment returns. An ICAP compensation mechanism is also needed to provide additional compensation for adequate returns on investment, so as to (a) avoid periods whether inadequate capacity exists on the system to provide reliable operation to meet demand, (b) help avoid periods of especially high electric energy prices associated with unreliable levels of scarce supplies (note that California lacks an ICAP compensation mechanism), and (c) assure that generating capacity is available to serve New England, as opposed to being exported to other regions.

Sithe appreciates the opportunity to provide the Department with these comments and looks forward to participating in this and other proceedings regarding the state of electricity markets in the Commonwealth and region.

Sincerely,

John O'Brien
Vice President

Attachments (2)

cc: Mary Cottrell, Secretary
Paul Afonso, Esquire, General Counsel
Kevin Brannelly, Rates Division
Ronald LeComte, Electric Power Division
Jeanne Voveris, Esq.